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NICK VAN RENSBURG: Many market assumptions are no longer valid

Geopolitics matter, fiscal policy is more powerful and risk-free US assets may not be risk-free in future

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19 JANUARY 2024 - 05:00

Picture: 123RF

We believe many embedded market assumptions are no longer valid. For decades, geopolitics was mostly irrelevant; interest rates were broadly falling; companies sent factories to China, which kept inflation and wages low while boosting profits; we lived in a unipolar world dominated by the US and with global trade protected by the US navy; and social media was a mere distraction, while monetary policy served as a market tailwind.

Today, geopolitics is relevant — we have a great power competition between the top two economies. Interest rates are higher; supply chains are being moved from China to other emerging markets and the US; we worry about the cost of climate change; social media has influenced voter behaviour, which in turn threatens democracy; and fiscal policy has superseded monetary policy since 2020. The effects of rapid progress in artificial intelligence (AI) add new uncertainty.

Geopolitically, the war between Russia and Ukraine affected the price of food and energy for a couple of quarters. While the Israel-Hamas war has not affected inflation directly, subsequent Houthi attacks in the Red Sea have caused a 120% rise in global freight rates over the past six weeks and could cause at least a temporary end to falling goods prices. Any direct military interactions involving Iran could affect the price of energy, with the situation in the Middle East still escalating. This, along with sticky wage inflation, could threaten the consensus positioning for aggressive interest rate cuts by the Fed.

The shift to fiscal stimulus from monetary stimulus introduced demand shocks and inflation to far greater effect than monetary policy ever did. This fiscal shift caused US debt to spiral higher and, as a result, US interest expense will exceed US defence spending in 2024. Historian Niall Ferguson believes this to be an ominous statistic for the US empire.

A proposed Group of Seven (G7) meeting at the end of February will discuss proposals to seize about $300bn in Russian central bank assets that were frozen when Russia invaded Ukraine. The proposal suggests seizing the frozen assets and handing them to Ukraine as war reparations. The freeze order was unprecedented, and so would any potential seizure be.

Seizure could cause a significant loss of face for President Vladimir Putin ahead of Russian elections and allow Ukraine to fund the war for longer or, alternatively, to fund the post-war rebuilding of Ukraine. It could also create unprecedented risks for US treasuries.

It would permanently change the perceived risk-free nature of US treasuries, which would be risk-free only to friends of the US, while having 100% potential downside in the hands of US enemies.

If the asset itself is not risk-free any more, how would this affect global discount rates, which underlie asset valuation? Gold could do very well under this scenario.

Another key risk for 2024 is the effect of social media on elections. Fake news travels seven times faster than truth and enables separate groups to live in separate information spaces. The truth a Donald Trump supporter perceives is wildly different from the truth a Joe Biden supporter perceives. Their versions of truth do not overlap much, which is the reason for political division in the US being at multi-decade highs.

Truth has, unfortunately, been losing value since 2016. The data available to social media platforms today far exceeds the data that allowed Cambridge Analytica to enable Brexit and Trump.

This brings us to a calendar fluke, as countries contributing 60% of global GDP are holding elections in 2024.

The Taiwan election this past weekend increased the risk of friction between China, Taiwan and the US over the next four years of rule by the Democratic Progressive Party, which rejects China's sovereignty claims over the island.

Russia will have a mostly predetermined election in March, followed by India, SA, the UK, and the EU all during the second quarter, and finally the US election in November.

Geopolitical risk consultancy Eurasia Group has named "the US vs itself" as its number one geopolitical risk for 2024. This is unthinkable for most investors.

It creates an interesting conundrum for the greatest recency bias we have witnessed in our careers: the love for US equities and US treasuries.

US equities account for 63% of total global equity market value, while US bonds account for 41% of global sovereign bond market value. The US contributes 26% of global GDP. The extraordinary large positioning in US assets indicates investors perceive that country as exceptionally low risk. But is the risk that low? Eurasia Group does not believe so.

Foreign investors own US assets equivalent to 100% of US GDP. If they ever stop buying, and start selling US assets, the dollar will fall. US outflows could benefit much cheaper rest-of-world markets.

We now live in a world where geopolitics matters, where fiscal stimulus is more powerful than monetary stimulus, where social media can drive up political risks even in the US, and where the risk-free rate might not be risk-free. AI adds positive and negative uncertainty.

In a multipolar world, the great competing powers lose at the margin, while non-aligned countries win. SA could be a net beneficiary of a multipolar world order if it chooses to be non-aligned.

The foundational shift in macro and geopolitical variables are likely to affect valuations. Foreign investors in US assets might want to take notice.

• Van Rensburg is a strategy consultant to All Weather Capital.

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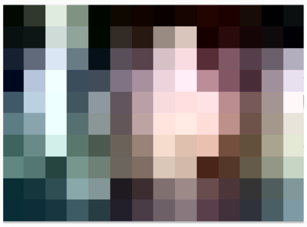

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